

What is a management rights letter and why is my investor asking for it?

What are they?

A letter agreement between a company and an investing venture capital fund which provides the fund with certain "management rights" that allow it to substantially participate in, or substantially influence the conduct of, the management of the portfolio company.

Why are they important?

A management rights letter is critical for any venture capital fund that is seeking to rely upon the venture capital operating company (VCOC) exemption in order to avoid its assets from being subject to the Employee Retirement Income Security Act of 1974 (ERISA) and the onerous requirements that would be imposed thereunder (which would include managers of the fund becoming personal fiduciaries under ERISA with respect to any private pension plans that invest in the fund and becoming subject to a set of strict prohibited transaction rules and conflict of interest and self-dealing issues as a result of the fund manager's receipt of performance fees in the form of its carried interest).

As background, private pension plans constitute a meaningful percentage of the investors in venture capital funds. The assets of such pension plans are subject to ERISA. When a venture capital fund takes in investors who are themselves subject to ERISA, the fund will want to avoid the assets of the fund from also becoming subject to ERISA. There are two exemptions that a venture capital fund can seek to rely upon in order to avoid such an outcome:

1. *The Not Significant Participation Exemption (ie, the 25 percent test)*

- If less than 25 percent of each class of equity interests of the venture capital fund (and a fund typically only has one class of equity interest) is held by investors who are subject to ERISA, then the assets of the fund will not be subject to ERISA.
- In determining whether the 25 percent threshold has been surpassed, investments by public pension plans and non-US pension plans are not counted towards the threshold.

2. *The VCOC Exemption*

- If the venture capital fund qualifies as a VCOC, then the assets of the fund will not be subject to ERISA.
- In order to qualify as a VCOC:
 - at least 50 percent of the fund's assets must be invested in operating companies in which the fund has direct contractual management rights (which is where the management rights letter comes into play) and
 - the fund must exercise such management rights with respect to at least one operating company that it holds an

investment in

- The 50 percent requirement must be met on the date the venture capital fund makes its first investment.
- The securing of a management rights letter by a venture capital fund is critical in that it is the means through which the fund has direct contractual management rights in its underlying portfolio companies.

What should they contain?

A management rights letter should secure as many of the following rights as possible for the investing venture capital fund:

- The right to appoint one or more directors to the board of the portfolio company
- The right to regularly informally consult with and advise the management team of the portfolio company
- The right to receive quarterly and annual financial statements of the portfolio company, including the annual auditor's report
- The right to examine the books and records of the portfolio company
- The right to receive copies of all documents, reports, financial data and other information that the fund may reasonably request and
- The right to appoint a person to serve as the corporate officer of the portfolio company

Potential traps

- Rights that a venture capital fund secures and shares with other investors do not count as management rights for purposes of meeting the VCOC exemption (*ie*, the rights must be individual to the fund). Thus parallel funds or related co-investment funds should each obtain separate management rights letters.
- Portfolio company investments, which are made by a venture capital fund indirectly through a special purpose vehicle, which is not wholly owned by such fund can be an issue in situations where the special purpose vehicle only holds a minority position in the underlying portfolio company. In that scenario, the special purpose vehicle will not be treated as an operating company for purposes of the VCOC exemption due to the fact that it is not primarily engaged, directly or through a majority owned subsidiary, in the production or sale of a product or service other than the investment of capital.
- If a venture capital fund seeking to rely on the VCOC exemption makes an investment which does not qualify as an investment in an operating company prior to making its first investment in an operating company, then such fund can never qualify as a VCOC.

Takeaway

A management rights letter is a key aspect for venture capital funds when investing in companies, as it enables funds to raise capital without subjecting the activities of the fund to the various restrictions imposed under ERISA. Requests for management rights letters are fairly common in today's market and do not impose significant burdens on the companies from whom such letters are sought.



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